BUSWEL Policy Brief: Corporate Tax Avoidance[1]

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Summary
Taxing multi-national corporations poses a challenge for national governments since multi-national corporations are often able to shift their incomes to low-tax jurisdiction using a variety of accounting techniques. Tax competition between national governments relies on companies making use of such techniques. This policy brief provides an overview of the topic of corporate tax avoidance. It consists of three parts. First, it provides a non-technical overview of the most common methods that multi-national corporations use to legally minimize their tax liabilities.

Second, it discusses the main regulatory initiatives at the global and European levels that aim to tackle the challenge of eroding revenues from corporate income tax due to companies shifting profits to low-tax jurisdictions. These efforts to stop corporate tax avoidance have gained considerable momentum since 2013, but are likely to turn out as insufficient to stop corporate tax avoidance. The regulatory initiatives adopted or currently discussed at the international level pursue a piecemeal approach of closing loopholes in the existing system of international corporate taxation. However, low-tax jurisdictions may respond to these closing of loopholes by a further lowering of statutory tax rates or an expansion of preferential tax arrangements, thus potentially neutralizing regulatory efforts by inducing a shift from profit shifting to investment shifting.

The brief presents a proposal for a more radical overhaul of global corporate taxation consisting of a combination of a global unitary tax and a limited range of statutory tax rates, whereby the rates permissible will be adjusted to a jurisdiction's level of economic development, allowing less developed countries to use tax incentives to attract investments within defined limits. Public country-by-country reporting and a global register of beneficial owners are proposed to augment a global unitary tax.

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1. **What is the problem?**

Taxing multi-national corporations (MNCs) poses a challenge to national governments in a globalized economy. MNCs can shift profits across countries to reduce their tax payments, a problem that gained public attention in recent years due to several high-profile leaks of documents covered in the media, including the Luxembourg Leaks in 2014, the Panama Papers in 2015, and the Paradise Papers in 2017. These documents illustrate the strategies used by MNCs and wealthy individuals to reduce their tax payments and have received considerable attention in the media. The enhanced media coverage raised also public awareness of the issue.

At the core of corporate efforts to reduce their tax payments are strategies designed to shift profits to zero-or-low-tax jurisdictions, that is, countries where the tax code allows MNCs to achieve lower effective tax wedge on profits. This can either be jurisdictions with low statutory tax rates, jurisdictions with favourable tax arrangements for specific types of investments, or jurisdictions that offer favourable tax arrangements for specific firms, for instance through advance tax rulings between a national tax authority and a major multinational corporation. One example of a favourable tax arrangement are special tax exemptions for intellectual property rights, which create incentives for firms to relocate these rights. In Luxembourg, for instance, the statutory tax rate on corporate income is 29.22 per cent, but income from intellectual property and royalties are taxed at only 5.7 per cent, with the effect that many companies that are tax-registered in Luxembourg pay taxes at an effective rate well below 29.22 per cent.

The methods MNCs use to shift profits to low-tax jurisdictions or jurisdictions with favourable tax arrangements exploit opportunities created or tolerated by these jurisdictions. By offering MNCs favorable terms of taxation, these jurisdictions intend to attract foreign investors. Decisions by governments to attract foreign investors through favourable tax rules or lower rates can lead to tax competition, where countries are competing for investors. The availability of profit shifting is a necessary condition for tax competition to work, since many of the relevant tax rules imply that companies shift their profits across countries. If no measures were taken against profit shifting, this could potentially lead to an erosion of revenues from corporate taxation, and in turn require governments to increase taxes on immobile factors, like labour, to compensate for this shortfall. A likely results of profit shifting is thus a shift of the tax burden from corporate income to labour income.

Available research in economics shows that the scope of profit shifting is considerable. The OECD estimates that globally about 4 to 10 per cent of corporate tax revenues are lost due to profit shifting. This is equivalent to about 100 to 240 billion US $ per year (OECD 2016: 2). A study by Dover et al , commissioned by the European Parliament, finds that revenue loss of EU member states due to profit shifting could amount to around 50 to 70 billion Euros, the authors note that this is a lower-end estimate. If other factors, such as the effects of special tax arrangements and inefficiencies in tax collection are included, the total revenue loss due to corporate tax avoidance amounts to 160 to 190 billion Euro, again a conservative estimate. (Dover et al. 2015: 5).

What strategies do MNCs use to reduce their tax burden? MNCs use accounting techniques to make their profits occur in low-tax jurisdictions even if the economic activity that generated the profit took place elsewhere. MNCs can use a variety of tools to shift profits across countries. Some important methods are:

a) **the use of transfer prices for intangibles:**
   Transfer prices are prices paid for transactions between affiliates of a MNCs located in different countries. For example, an affiliate located in country A may sell a good or service to another affiliate of the same MNC in country B. The price charged for this transaction will affect the allocation of the profit made to the two affiliates. If the MNC increases the price this will increase the profits made by the affiliate that sells

the good, and reduce the profits of the affiliate that buys the good. Current rules require that MNCs apply what is known as the 'arm's length principle' when calculating transfer prices. This means they are supposed to charge the same price to an affiliate as what they would charge an unrelated third party.
While this rule seems reasonable in principle, it is difficult to apply to intellectual property rights, like patents or trademark rights. Such goods are often traded only within an MNC and it is difficult to calculate the market price that a third party would need to pay, since these goods are not traded on markets. The arm's length principle thus involves problems of application and its enforcement frequently leads to conflicts between tax authorities and MNCs.

b) **The digital economy and avoidance of permanent establishment status:**
The rise of the digital economy made it easier for MNCs to do business in countries without establishing a physical presence there. By using the internet, companies can sell their products in countries where they are not registered for tax purposes, that is, where they do not have a 'permanent establishment'. Several prominent firms operating in the digital economy are registered for tax purposes in jurisdictions that offer favorable tax arrangements for intellectual property rights. Examples are Amazon, which is registered in Luxembourg, and Facebook, which is registered in Ireland. In reality, both companies make a large share of their profits by selling goods and services in other European countries. The digitalization of the economy, therefore, creates problems related to the allocation of profits for tax purposes. Outdated tax rules that have been designed for an industrial economy can be exploited by new economy firms to allocate profits in low-tax jurisdictions or jurisdictions with favorable tax arrangements as they easily explore the legislative loopholes created by outdated law.

c) **Deductibility of interest payments:**
Companies can in general deduct payments of interest from profits. This sometimes enables MNCs to use internal loans for purposes of tax planning. Interest payments may reduce the profit (tax base) of the affiliate receiving the loan and increase the profits of the affiliate granting it. To give an example, in 2013 the New York Times reported that the company Apple borrowed 17 billion US $ from a subsidiary even though it had at that time 145 billion US $ in cash reserves, a move apparently intended to reduce its tax base (Norris 2013).

d) **Mergers and Acquisitions:**
Companies can sometimes relocate their tax residence to a lower-tax jurisdiction when merging with another company, which is called 'tax inversion.' Tax inversion occurs when a company located in a high-tax jurisdiction merges with a company in a low-tax jurisdiction and the merged company is re-domiciled in the low-tax jurisdiction. An example of this practice is the attempted merger of the two pharmaceutical firms Pfizer Inc, a US-based firm, and Allergan Plc, a firm based in Ireland. The planned merger was expected to cut Pfizer's annual tax bill by about 1 billion US$ (Humer and Banjerjee 2016). The two companies abandoned the planned merger in 2016 after a change in the US tax code.

In short, the globalization of the economy has enabled MNCs to use a range of accounting techniques to reduce the profits they report to the tax authorities in countries with high taxes or less favorable tax arrangements.

The underlying problem of all these techniques is that corporate taxes are raised at the national level, while MNCs operate at the global level. This enables MNCs to hide profits from national governments or to make them look lower than what they are. Moreover and equally important, the taxation of MNCs treats the national affiliates of MNCs as independent units, rather than treating MNCs as the integrated, global unit that in reality they are. MNCs design their tax planning strategies on a global level, for the entire MNC, while the existing system of corporate taxation treats every national affiliate of an MNCs like an independent unit. This means, for example, that the French tax authorities deal only with the taxation of the French affiliate of a company, while the German tax authorities deal only with the taxation of the German affiliate of the company. No national tax authority at present has an overview of the global activities of an MNC. In short, MNCs act as integrated global organizations, but for tax purposes each national affiliate is treated independently.

2. What are the obstacles to the regulation of profit shifting?

Stopping MNCs from shifting their profits to low-tax jurisdictions requires international cooperation. Regulatory changes by individual countries are ineffective as long as MNCs are able to shift profits to other countries with a lower level of taxation.

In principle, the international community could pursue two strategies to stop profit shifting:

I. **Harmonization of tax rates**: Countries could harmonize their tax rates or introduce a floor of tax rates that countries are not allowed to fall below. This would eliminate any incentives for MNCS to shift income.

II. **Regulation of profit shifting**: Regulations that restrict the opportunities for MNCs to shift profits to low-tax jurisdictions, for instance, through stricter rules for tax reporting and transparency, and intensified exchange of data between national tax authorities.

The main obstacle are conflicts of interests between high-tax and low-tax jurisdictions and a lack of political will to change the current setting, which is favourable to big multi-national companies. Countries that experience losses of tax revenues tend to favour tighter international regulations, while countries that attract foreign capital investors through favourable tax rules, often veto far-reaching reforms. While many countries are on the losing end of profit shifting consensus for international cooperation is thus difficult to achieve.

Consequently, for long periods of time progress on international regulations has been limited (Farquet 2016; Genschel and Schwarz 2011: 359-363) . Yet, since the financial crisis of 2007/08 efforts at international regulations have intensified. The budgetary constraints and pressures for austerity, together with increased media attention to corporate tax avoidance, have created momentum for reform.

3. The Base Erosion and Profit Shifting Project by the OECD and the G20

The main initiative is the 'Base Erosion and Profit Shifting' (BEPS) project, an initiative by the G20 and the OECD. At the G20 summit in Los Cabos, Mexico, in 2013 G20 government leaders mandated the OECD to develop new regulations intended to limit profit shifting. The principal goal of the BEPS project is to make sure that MNCs pay their taxes 'where economic activities take place and value is created' (OECD 2016). The OECD's Committee on Fiscal Affairs has developed a set of proposals for reforms to international tax rules that are intended to achieve this goal. The leaders of the G20 approved the OECD's recommendations at their summit in Anatalya on November 15-16, 2016.

The measures proposed by the OECD aim at preventing MNCs from shifting profits for tax purposes by improving documentation and reporting rules for MNCs. The action plan proposed by the OECD consists of 15 specific proposals ('action points') that are intended to make sure that companies report profits in that country were the economic activity that created the profit occurred. One cornerstone of the BEPS plan is what is called 'country-by-country' reporting (CbC Reporting), which means that in the future MNCs will be required to report a number of key indicators for each country in which they operate, including the number of employees, sales, and capital assets, and taxes paid. Tax authorities in all countries affected should have access to these data, which will allow them to carry out their own investigations of an MNC's activities using this data. CbC reporting should therefore make it easier for national tax authorities to analyse tax filings by MNCs for possible discrepancies. The demands by NGOs and academics to make CbC reports public was however not approved by the OECD. In the European Union, a limited form of public CbC Reporting is in place for the banking sector under the 4th Capital Requirements Directive (CRD IV) (European Union 2013).

In addition, the OECD's action plan includes, inter alia, recommendations to limit profit shifting via interest deduction, to prevent the artificial avoidance of permanent establishment status, and rules tightening the documentation of transfer prices (OECD 2016).

Academics and NGOs have criticised the measures of the BEPS project as ineffectual and not fear-reaching enough (Sikka 2015). According to the BEPS Monitoring Group, an independent group of tax lawyers, the OECD's BEPS project constitutes 'a patch up of existing rules … and do not provide a coherent and comprehensive set of reforms. Nevertheless, this is an important step on a longer road' (The BEPS Monitoring Group 2015: 1).

The main criticism of the BEPS project is that it sticks with the established 'arm's length principle', that is, the principle of treating each national affiliate of an MNC as an independent company, and taxed separately, rather than treating MNCs as global, integrated organisations, which, consequently, would also need to be taxed on a global level. Below we will present a proposal for a 'global unitary tax' as one option for further-going reform.

Another limitation of the OECD/G20 BEPS project is that its recommendations, even though approved in principle by all OECD and G20 member states, are not legally binding in themselves and thus much depends on the willingness of member states to implement them. How strict governments will be in implementing the OECD's recommendations will partly depend also on public and media pressure. Progressive movements need to pay attention to whether and how low-tax jurisdictions comply with the BEPS recommendations by the OECD and G20.

4. Regulatory Initiatives by the European Union

Within Europe, the measures proposed by the OECD and G20 are complemented by initiatives by the European Union, some of them adopted, others under discussion. Some of these measures serve to implement the OECD/G20 recommendations within the EU, others go beyond what the OECD and G20 recommend. The most relevant initiatives at the EU level are proposals for a Common Consolidated Corporate Tax Base (CCCTB) and proposals to introduce public Country-by-Country reporting within the EU.

A Common Consolidated Corporate Tax Base was first proposed by the European Commission in 2011. The proposal aims to consolidate corporate profits at the EU level so as to make the shifting of profits for tax purposes among EU member states pointless for MNCs. Corporate income would be determined at the EU level, rather than at the member state level, and then, in a second step, be apportioned to individual member states, using a formula that is supposed to reflect the size of economic activities in each member state. As a third step, each member state would then tax its portion of the EU-wide profit based on its own rules. Due to resistance from some countries and the unanimity requirement on tax policy in the Council, the CCCTB has however so far not been passed. The Commission has however re-launched its initiative for a CCCTB in June 2015 (European Commission 2015b).

Proposals by civil society groups and academics for Public Country-by-Country reporting are also on the agenda the EU. These proposals go beyond the recommendations of the OECD and G20 by making the data that MNCs need to report publicly available, in order to allow interested actors, like journalists for instance, to scrutinize them on their own. As mentioned earlier, for the banking sector public CbC reporting is already in force in the EU since 2014/2015, as part of the Capital Requirements Directive IV. On 8th July 2015 the European Parliament voted in favour of extending public CbC reporting to all sectors, as part of the Shareholders' Rights Directive, but negotiations between the Council and the Commission are still going on (Meinzer 2017).

While the two proposals discussed so far, CCCTB and CbC reporting, met with considerable political obstacles, including opposition from some member state, a number of other, smaller and more incremental measures, were adopted by the EU during the last three years. In January 2016, the European Commission presented a proposal for a comprehensive Anti-Tax Avoidance Package, which includes, inter alia, new limits on the deductibility of interest payments, rules regarding controlled foreign companies, and rules against treaty shopping (European Commission 2016). The European Commission has also proposed legislation for the automatic exchange of information on national tax rulings through the Revised Administrative Cooperation Directive, which make it easier for national tax authorities to detect abusive practices by MNCs (European Commission 2015a). Another measure relevant for corporate tax avoidance is the list of tax havens, which does however not include any EU member states (Meinzer and Knobel 2015).

To sum up, in recent years the European Union has become much more active in combating corporate tax avoidance and several important initiatives emerged, yet important obstacles towards reaching political consensus on effective and meaningful measures remain. The measures adopted so far are steps into the right direction, but insufficient.

5. Which tools could be applied to overcome these transnational problems?

The initiatives by the G20/OECD and by the EU are a first step into the right direction, but they do not go far enough to prevent tax competition. The measures proposed and, partly, also adopted aim at enhancing tax transparency and reporting standards in order for national tax authorities to make it easier to detect unlawful forms of tax avoidance Yet, Progressive policy-makers should take advantage of the momentum created by the media attention and the G20/OECD's BEPS project to push for more far-reaching reforms. What further steps should be taken to limit tax competition? In these section, we present three policy recommendations for the transnational level

5.1 A global unitary tax

A global unitary tax would follow the same principal as the European Commission's proposal for a Common Consolidated Corporate Tax Base and apply globally, instead of only in the EU. A global application would have the advantage that any competitive disadvantage for firms based in the EU can be excluded. Under a global unitary tax, the total global profit of an MNCs is determined and then divided up among those countries where the MNCs has genuine economic activity. Portions of the group's profit would be allocated to individual countries, using a formula that includes indicators of genuine economic activity, like the number of employees, turnover per country, and physical assets, a method called **formula apportionment**. Under this proposal, each country would still be free to set its own tax rate, but incentives for MNCs to use methods of tax planning to shift profits across countries would be removed, since profit shifting would stop to have an effect on a company's tax burden. The implementation of such a global unitary tax should be overseen by an existing international organisation, such as the OECD or the IMF, or by a newly created body.

A global unitary tax should be combined with a range of permissible tax rates and tax exemptions to regulate tax competition. Less developed countries could, for instance, be allowed to charge a lower statutory rate or to offer preferential tax arrangements. This would allow them to attract real investments, as opposed to profits shifting, and at the same time prevent aggressive forms of tax competition.

A global unitary tax is certainly the most radial proposal and also politically least likely to be successful. Despite its rather low chances of implementation it is important to put it on the political agenda in order to maintain the momentum for reform.

5.2 Global public country-by-country reporting

Public country-by-country reporting allows the public to see how much economic activity MNCs have in individual countries and creates greater transparency. The OECD/G20 proposals for CbC reporting limit access to selected national tax authorities, but do not include access to the public. The existing EU's requirements for public CbC reporting are limited to the banking sector and should be extended to all sectors of the economy. In addition, it needs to be ensured that data are indeed provided for individual countries, rather than for groups of countries. Proposals for worldwide public CbC reporting have a greater chance of implementation than a global unitary tax, but much depends on whether progressive movements manage to maintain the momentum for reform.

The EU should take the lead in adopting public CbC reporting for all sectors and at the same time put pressure on countries outside the EU to adopt public CbC reporting.

5.3 A global register of beneficial owners

A worldwide public register of the beneficial owners of companies is needed to restrict the use of tax havens by wealthy individuals, whose wealth often comes from business activities. Such a register already exists in the UK and has been adopted by the European Union for its member states on 15 December 2017 (Ryding 2018: 3; Eurodad 2017).

The European Union has taken the lead to introduce a public register of ultimate ownership and should use its influence to put pressure on countries outside the EU to support the adoption of a worldwide.

6. Conclusions

a global unitary tax based on formula apportionment and a range of permissible parameters for national tax policies would eliminate opportunities for firms to artificially shift profits to low-tax jurisdictions and thus shift tax competition from profit shifting to real investments, while at the same time limiting extreme forms of tax competition. A global unitary tax should be supplemented with the publication of country-by-country reports and a global public registry of beneficial owners.

The implementation of a global unitary tax faces considerable political obstacle. Opposition comes from two groups: low-tax jurisdictions and those multi-national corporations that expect a higher global tax liability. Compensatory offers to low-tax jurisdictions and tax secrecy jurisdictions will most likely be key to an international agreement.

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